Cases—Continued

	Page
North American Oil Consolidated v. *Commissioner*, 12 B. T. A. 68, reversed on other grounds 50 F. 2d 752, affirmed 286 U. S. 417	30
Palmer v. *Bender*, 287 U. S. 551	11, 15, 16, 19, 20
Procter and Gamble Manufacturing Co. v. *Commissioner*, decided February 18, 1946	12
Quintana Petroleum Co. v. *Commissioner*, 44 B. T. A. 624	13, 31
Schermerhorn Oil Corp. v. *Commissioner*, 46 B. T. A. 151	30
Stratton's Independence v. *Howbert*, 231 U. S. 399	17
Thomas v. *Perkins*, 301 U. S. 655	9, 11, 15, 19
United States v. *Dakota-Montana Oil Co.*, 288 U. S. 459	30
Von Baumbach v. *Sargent Land Co.*, 242 U. S. 503	8, 18
West v. *Commissioner*, 150 F. 2d 723, certiorari denied January 28, 1946	11, 22
Williams Bar Dredging Co. v. *Commissioner*, decided June 30, 1945	19
Woolford Realty Co. v. *Rose*, 286 U. S. 319	25
Statutes:	
Revenue Act of 1932, c. 209, 47 Stat. 169, Sec. 114	8
Revenue Act of 1934, c. 277, 48 Stat. 680:	
Sec. 22	34
Sec. 23	30, 34
Sec. 113	30, 34
Sec. 114	7, 8, 30, 34
Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Sec. 22	32
Sec. 23	30, 32
Sec. 113	30, 33
Sec. 114	7, 8, 30, 33
Miscellaneous:	
H. Conference Rep. No. 1492, 72nd Cong., 1st Sess., p. 14 (1939—1 Cum. Bull. (Part 2) 539, 542)	8
2 Summers, *The Law of Oil and Gas*, Sec. 284	20
Treasury Regulations 86:	
Art. 22 (a)–1	36
Art. 23 (a)–1	36
Art. 23 (m)–1	36
Art. 23 (m)–4	36
Treasury Regulations 94:	
Art. 22 (a)–1	34
Art. 23 (a)–1	34
Art. 23 (m)–1	35
Art. 23 (m)–4	36

In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 361

BURTON-SUTTON OIL COMPANY, INCORPORATED,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 42–58) is reported at 3 T. C. 1187. The opinion of the Circuit Court of Appeals (R. 66–72) is reported at 150 F. 2d 621.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 6, 1945 (R. 76). The petition for a writ of certiorari was filed on August 23, 1945, and was granted on February 11, 1946 (R. 78). The jurisdiction of this Court is in-

voked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer who acquired the working interest in an oil and gas lease, agreeing to pay 50 percent of its net profits to the assignor of its transferor and to pay oil royalties to others, may exclude or deduct from its gross taxable income an amount equal to the net profits payments.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and regulations involved are set forth in the Appendix, *infra*, pp. 32–36.

STATEMENT

The facts in this case were stipulated by the parties (R. 34–41), and were found by the Tax Court in accordance with the stipulation (R. 51).

The taxpayer is a corporation, organized in 1933 and having its principal office in Louisiana where it carried on its business. Its books were kept and its tax returns were prepared on the accrual basis (R. 34–35, 44). In 1933, the taxpayer acquired the working interest in a certain oil and gas lease in Louisiana which had been executed by the Cameron Parish School Board, as lessor (R. 35, 45). The taxpayer's interest in this lease was procured, by contract, from J. G. Sutton, who had obtained the working interest from the Gulf Refining Company of Louisiana, referred to

herein as Gulf. (R. 35, 45). The agreement between Sutton and Gulf, which was acquired by the taxpayer, provided that Gulf (R. 35):

> has sold, conveyed and transferred * * * all oil and gas rights, titles, interests or privileges given, conveyed and transferred by virtue of that certain mineral lease executed by Cameron Parish School Board to S. W. Sweeney, dated April 4, 1927, covering all of the whole of Section Sixteen (16), Township Fourteen (14) South, Range Thirteen (13) West, Louisiana Meridian, in Cameron Parish, Louisiana.

The agreement, which was termed an "assignment", provided, in Paragraph 1 (R. 35–36), that the grantee was to commence drilling operations within 30 days and to continue with reasonable diligence in an effort to find oil or gas in paying quantities. After the completion of the first well, the grantee was obligated to continue—

> such operations on said land as may be necessary to continue said lease in full force and effect. If, after completing said well, Grantee shall desire to cease operations on said land, he shall, upon demand, reassign said lease to Grantor not less than thirty days prior to the maturity date of any obligation accruing after the date of the cessation of his operations on said land.

Paragraphs 2 and 3 provided that the grantee should pay the royalties provided for in the original lease, as well as an overriding royalty to the

original lessee, together with all expenses of operations. After having paid the underlying and overriding royalties, and after having been reimbursed from the proceeds of the oil and gas produced for all expenses of operation, the grantee was obligated to account and pay to the grantor 50 percent of the remaining proceeds (R. 36, 46).

Paragraph 4 provided when settlement should be made with Gulf, and Paragraph 5 specified in detail what costs and expenses could be deducted from the gross proceeds before division of the net profits was required to be made (R. 36–38, 46). Paragraph 7 provided that Gulf should not be obligated to pay any of the costs or expenses incurred by the grantee in his operations under the agreement (R. 38, 46). Paragraph 8 reserved to the grantor all sulphur rights in the property (R. 38, 46–47). The final paragraph specified the manner in which the oil produced on the land was to be sold, and gave Gulf the right to purchase the oil at the average posted price, if it so desired (R. 38–39, 47).

During the fiscal years ending on the last day of February, and pursuant to Paragraph 3 of the contract, the taxpayer paid the following sums to Gulf as its share of the net profits (R. 39–47):

1936	$17,408.10
1937	232,408.94
1938	286,128.28

The taxpayer deducted the above amounts in its tax returns for the respective years; the Commis-

sioner disallowed the deductions on the ground that these amounts represented additional costs of the property and were recoverable through the depletion allowance (R. 39). The Tax Court and the Circuit Court of Appeals sustained the Commissioner's determination, holding that the payments to Gulf were not to be excluded or deducted from the taxpayer's gross taxable income (R. 51–59, 66–76).

SUMMARY OF ARGUMENT

An interest in net profits from the operation of an oil and gas lease is not subject to the allowance for depletion unless it is associated with an economic interest in the oil and gas in place. In determining whether one who has the right to share in net profits has the requisite economic interest, no importance is to be attached to the type of instrument by which the transfer of exploitation rights was accomplished or to the presence or absence of legal title, in the transferor, to the deposits; rather, the depletable interests of the parties are to be determined exclusively by the provisions for payment. Under the decisions of this Court, such interests only exist where there is a right to share in gross production of the oil or its proceeds, and the right to receive a share of net operating profits is not depletable unless the recipient is also entitled to receive oil royalties. Accordingly, in the present case, when Gulf assigned its interests in the oil

and gas leases, and only retained the right to share in the net profits from operations, it no longer had an economic interest in the oil and gas in place, it was not entitled to the depletion allowance with respect to the net profit payments it received, and the taxpayer may not exclude from its gross taxable income, as "rents or royalties," the payments to Gulf.

Even if the provision for payment should not be considered as the exclusive criterion of the existence of a depletable interest, the decision below is correct for the reason that Gulf "sold" its entire interest to the taxpayer, and this case is, therefore, not distinguishable from *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372.

The net profit payments made by the taxpayer to Gulf constitute the purchase price of the taxpayer's capital investment in the property which is recoverable only through the allowance to the taxpayer for depletion. Accordingly, the payments may not be deducted by the taxpayer as an ordinary and necessary business expense under Section 23 (a) of the Revenue Acts of 1934 and 1936.

ARGUMENT

The taxpayer may not exclude or deduct from its taxable gross income that portion of its net profits from operating an oil and gas lease paid to its assignor's transferor

The taxpayer in this case acquired the working interest in a certain oil and gas lease from J. G.

Sutton who, in turn, had obtained his rights by assignment from the Gulf Refining Company of Louisiana, referred to as Gulf (R. 35, 45).[1] Under the assignment, the taxpayer was obligated to pay underlying and over-riding royalties to the original lessor and original lessee; Gulf was entitled to receive 50 percent of the taxpayer's net profits from operations, the assignment providing what expenses were to be deducted from gross revenues in calculating the profits (R. 36–38, 46–47).

1. The precise issue presented for decision is whether the taxpayer may exclude or deduct from its taxable income the net profit payments made to Gulf during the taxable years. Whether an amount equal to the payments is to be excluded from the taxpayer's gross taxable income obtained from operations presents the same basic issue as whether those payments are "gross income from the property" to Gulf, payments on which Gulf would be entitled to percentage depletion under Section 114 (b) (3) of the Revenue Acts of 1934 and 1936 (Appendix, *infra*, pp. 33–34) *Anderson* v. *Helvering*, 310 U. S. 404, 407. The identity of these issues derives from the fact that the aggregate of the single allowance for percentage depletion to be deducted by the holder of the working interest and by all others sharing in produc-

[1] For purposes of simplification, the taxpayer may be considered as being Gulf's assignee and will be referred to in that manner.

tion cannot exceed 27½ percent of the gross proceeds from the sale of the oil and gas. The Revenue Act of 1926, c. 27, 44 Stat. 9, was so construed in *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, and Congress, beginning in Section 114 (b) (3) of the Revenue Act of 1932, c. 209, 47 Stat. 169, has enacted that rule [2] by providing, in effect, that the holder of the working interest is not entitled to percentage depletion on any "rents or royalties" [3] paid, it being required that an amount equal to such payments (as to which others would be entitled to depletion) be excluded from a taxpayer's gross income from the property. The amounts which are thus excluded from the depletion basis are likewise excluded from the operator's gross taxable income since he is merely paying to others the proceeds from the sale

[2] H. Conference Rep. No. 1492, 72nd Cong., 1st sess., p. 11 (1939—1 Cum. Bull. (Part 2) 539, 542).

[3] The term "rents" in Section 114 (b) (3) is used synonymously with the word "royalties". The latter clearly refers to a share of gross production or the proceeds thereof (*Anderson* v. *Helvering*, 310 U. S. 404, 409) and the term "rents or royalties" has been used to describe a stipulated amount payable per ton for the privilege of extracting iron ore (*Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 522). If there is any shading of meaning between the two words, it is clear that the word "rents" is not used in its ordinary sense, since in order to constitute gross income from the property to the recipient, it must be "gross income from the oil and gas". *Helvering* v. *Mountain Producers Corp.*, 303 U. S. 376, 382. Thus, the word "rents" like the word "royalties" denotes payments received from the production of oil and gas.

of oil belonging to them. *Thomas* v. *Perkins*, 301 U. S. 655. "Such deductions become the gross income of the lessor." *Kirby Petroleum Co.* v. *Commissioner*, decided by this Court on January 28, 1946, No. 56, this Term, slip opinion, pp. 4–5.

As a result, if Gulf does not have an economic interest in the oil in place and is not entitled to the depletion allowance with respect to the net profit payments received, the taxpayer has not sold any oil in which Gulf has an interest, and there is nothing in the statute or Regulations permitting the taxpayer to exclude an amount equal to these payments from its taxable income derived from operations.[4] The taxpayer agrees with these fundamental principles (Br. 7–11).

This Court has already passed on the question whether a right to share in net profits derived from the production and sale of oil is a depletable interest, as presented in three different settings. In *Helvering* v. *O'Donnell*, 303 U. S. 370, it was decided that one who had no previous economic investment in the oil deposits did not obtain a depletable interest by acquiring the right to share in net operating profits under a contract providing for the sale of corporate stock. *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372, determined that one who had previously possessed an economic interest in the oil in place, but had sold all his

[4] Whether the payments are to be included in the taxpayer's gross income, but are deductible as business expenses is discussed at pp. 30–31, *infra*.

right, title and interest in certain oil and gas leases, prospecting permits, and equipment, no longer had a depletable interest even though he was still entitled to a stipulated percentage of the net profits. In *Kirby Petroleum Co.* v. *Commissioner*, *supra*, it was held that a lessor who received a share of gross production by way of oil royalties and also a portion of net operating profits was entitled to calculate percentage depletion by including both payments in its "gross income from the property". The *Kirby* opinion also indicated (slip opinion, p. 5) that the lessee could exclude both payments from its gross income as "rents or royalties" paid.

When these cases are considered together, it must be evident that an interest in net profits cannot, by itself, be decisive of the existence of an economic interest in the oil and gas in place which entitles the owner to a deduction for depletion. That is, before it can be determined whether the recipient of net profit payments may claim the depletion allowance, other factors must appear showing his relationship to the oil deposits. If a taxpayer who merely shares in profits has no other economic interest in the minerals, the *O'Donnell* and *Elbe* cases would require that he be denied the depletion deduction. Thus, the fact that Gulf was entitled to receive a portion of the taxpayer's net profits from operations does not, of itself, evidence Gulf's depletable interest or

establish the taxpayer's right to exclude anything from its gross taxable income.

We do not understand that the *Kirby* case has detracted from the force of the *O'Donnell* and *Elbe* decisions. On the contrary, the *Kirby* opinion, referring to those cases with approval, stated that *Anderson* v. *Helvering*, 310 U. S. 404, had correctly summarized the decisions as holding (slip opinion, p. 6): "that a share in 'net profits' dissociated from an economic interest, does not entitle the holder to a depletion allowance." In this respect, the *Kirby* decision must be regarded as establishing that an interest in net profits differs from the right to share in gross production which, regardless of all other circumstances, is always a depletable interest and constitutes "gross income from the property" to the recipient. *Thomas* v. *Perkins*, 301 U. S. 655;[5] *Palmer* v. *Bender*, 287 U. S. 551; *Bankers Coal Co.* v. *Burnet*, 287 U. S. 308; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299; *Burnet* v. *Harmel*, 287 U. S. 103; *West* v. *Commissioner*, 150 F. 2d 723 (C. C. A. 5th), certiorari denied January 28, 1946, Nos. 667, 668, 669, and 670, this Term.

While there are some statements in the *Kirby* opinion which, if read alone, might be taken to mean that a share of net profits is, of itself, a depletable interest, it seems clear that such a prin-

[5] (Slip opinion, p. 4):

"If the additional payment in these leases had been a portion of the gross receipts from the sale of the oil extracted

ciple, which would have required overruling the *Elbe* and *O'Donnell* decisions, was not announced by the Court. This is especially true in view of the reaffirmation of those cases by the *Kirby* opinion and in the light of the court's statement, in the *Kirby* opinion, that an interest in net profits is not depletable when disassociated from an economic interest.

Starting with the premise that the recipient of net profits must have some additional economic interest in the oil deposits before the payments can evidence a depletable interest, it becomes pertinent to inquire what factors absent in the *Elbe*

---

by the lessees instead of a portion of the net profits, there would have been no doubt as to the economic interest of the lessors in such oil. This would be an oil royalty. The lessors' economic interest in the oil is no less when their right is to share a net profit. * * *"

(Slip opinion, p. 4, fn. 6):

"While the reservation of royalties shows an economic interest in the oil necessary for the satisfaction of the royalties, such reservation would not show an economic interest in oil not necessary for the payment of the royalties. But see *Estate of Japhet* [*Japhet*], 3 T. C. 86."

(Slip opinion, p. 5):

"If we assume that the only payment for the privilege of oil extraction made to the taxpayer lessors by the lessees was the portion of "net income" paid under the leases, it would be clear that such payment of "net income" would taxwise be rent or royalty paid by the lessees for the privilege of extraction. * * *"

The Tax Court has interpreted the last quoted excerpt as meaning that an interest in net profits is, by itself, depletable. *Procter and Gamble Manufacturing Co.* v. *Commissioner*, memorandum opinion, February 18, 1946, Docket No. 3338; *Murphy* v. *Commissioner*, decided February 28, 1946, 6 T. C. No. 42.

case were present in the *Kirby* case so that the payments were depletable in the latter but not in the former. While the *Kirby* opinion is not explicit in that regard, we are able to discern only two matters which might be of sufficient significance to distinguish the cases. In the *Kirby* case, the taxpayer had an economic investment in the oil, as evidenced by its retained royalty interest. Such an interest was not present in the *Elbe* or *O'Donnell* cases, and none was retained by Gulf in the present case. Accordingly, if the presence of oil royalties was the crucial factor on which the *Kirby* case was decided, this case is governed by the *Elbe* and *O'Donnell* decisions.

The *Elbe* case might also be distinguishable from the *Kirby* case on the ground that in the former there had been a "sale" or "assignment" of leases while in the latter the underlying oil was "leased". If this was the source of distinction between the cases, we also believe that the present controversy is governed by the *Elbe* case since here Gulf "sold, conveyed and transferred" "all oil and gas rights, titles and interests" created by the leases (R. 35), and did not reserve any rights in the oil, either before or after production. Indeed, from the fact that Gulf could, if it so desired, "purchase" from the taxpayer the "oil produced" (R. 38–39), it is evident that Gulf intended to make a complete "sale" of the oil deposits. It may be noted that both the Tax Court (by relying on its decision in *Quintana Petroleum Co.* v. *Commissioner*, 44 B. T. A. 624)

and the court below believed that this case was controlled by the *Elbe* decision. (R. 53–54, 88.)

Thus, if the *Kirby* decision rests on either or a combination of these circumstances, the taxpayer in this case may not exclude the payments from its gross income and Gulf does not have a depletable interest.

2. Although the decision below is sustainable on either ground, we believe that the previous decisions of this Court, which were not disapproved in the *Kirby* case, make it evident that the retention of the royalty interest was the factor in the *Kirby* case which entitled the lessor to depletion on the net profit payments; the circumstance that a lease had been executed was not sufficient to distinguish the *Elbe* case in which there had been a sale or an assignment of the leases. A precise ruling on this would clarify the principle to be applied in pending cases and would undoubtedly diminish future litigation affecting this problem. Ascertaining the dividing line between the *Elbe* and *Kirby* opinions becomes particularly difficult where a transferor of a lease retains an interest in net profits but is not entitled to any oil royalties, and to attempt to draw the line according to whether the transfer was an assignment or a sub-lease would not only make the statute difficult to administer but would be to revert to principles repeatedly rejected.

The consistent rulings of this Court demonstrate that the existence of a lessor-lessee relationship

can scarcely be regarded as material to the decision reached in the *Kirby* case. *Burnet* v. *Harmel*, 287 U. S. 103, held that differences in local law respecting title to the oil in place were not important and that, even though a lessee acquired title before severance under Texas law, and despite the receipt of an initial cash payment, a sale of a capital asset within the meaning of the federal taxing statute did not take place upon the execution of a typical oil and gas lease in Texas. The opinion emphasized the point that where the lessor received a bonus and oil royalties, whether the lessee acquired title before or after severance (p. 111)—

> The economic consequences to the lessor of the two types of lease are the same. Under both, the payments made by the lessee are consideration for the right which he acquires to enter upon and use the land for the purpose of exploiting it, * * *.

Palmer v. *Bender*, 287 U. S. 551, reiterated the principles that (pp. 555–556) "The formal attributes of those instruments or the descriptive terminology which may be applied to them in the local law are both irrelevant", that (p. 557) "the allowance for depletion is not made dependent upon the particular legal form of the taxpayer's interest in the property", and held that a depletable interest is acquired when one (p. 557) "secures, by any form of legal relationship, income derived from the extraction of the

oil, to which he must look for a return of his capital." Holding that the right to share in the production of oil was a depletable interest, the Court, in *Palmer* v. *Bender*, observed that a distinction based on the form of transfer was not material and refused to consider the question whether the particular instruments constituted subleases, with reversionary rights in the sublessor, or assignments.

Again, in *Thomas* v. *Perkins*, 301 U. S. 655, notwithstanding that the conveyance was an assignment, and despite the fact that the granting clause purported to transfer the oil in place to the assignee, it was ruled that the assignor retained a depletable interest by reserving an oil payment payable out of the oil as produced; consequently, it was held that the payments to the assignor were not part of the assignee's income. Summarizing this decision, and referring to *Palmer* v. *Bender*, *supra*, and *Burnet* v. *Harmel*, *supra*, the Court stated in *Anderson* v. *Helvering*, 310 U. S. 404, 411:

> The decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type.

Also, in the *Kirby* case, with reference to what constitutes an economic interest in the oil, it was stated (slip opinion, pp. 3–4):

> By this is meant only that under his contract he [a taxpayer] must look to the oil in place as the source of the return of his capital investment. The technical title to the oil in place is not important. Title in a case of a lease may depend upon the law of the state in which the deposit lies. *Burnet* v. *Harmel*, 287 U. S. 103, 109–110. The test of the right to depletion is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted. See *Anderson* v. *Helvering*, 310 U. S. 404, 407.

The reasons why an economic investment and depletable interest in the underlying oil are determined exclusively from the provisions for payments, and not from the kind of legal relationship involved, have been fully developed in the decided cases. They need only be outlined here. The owner of mineral property who extracts and sells the deposits has been held to be engaged in a business and not in the conversion of capital from one form to another. Although an ultimate sale of the severed deposits is always involved, such operations are distinguished from a sale of the property itself where the owner no longer will obtain a return from future operations. *Stratton's Independence* v. *Howbert*, 231 U. S. 399. Similarly, where the owner permits someone else to carry on the actual operations and to sell the severed minerals, each being entitled to a portion of the gross product or the gross proceeds from its sale,

no sale of a capital investment takes place. While ownership of the deposits passes at some time from the owner to the operator, the owner's receipts are not derived from the sale of a capital asset but are considered as ordinary income, his capital investment, like that of the operator, being returned by the statutory allowance for depletion. *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503; *Lynch* v. *Alworth-Stephens* Co., 267 U. S. 364. As a result of the peculiar conditions of the industry, regardless of when ownership passes under local law, no sale of a capital asset takes place if the owner retains a continuing share of gross production or the proceeds therefrom. *Burnet* v. *Harmel*, 287 U. S. 103.

A further basis for disregarding legal title to the oil, which is fully as important as the practical economic considerations, lies in the fact that such legal relationships are determined under local law. Since variations occur from State to State, a uniform impact of the taxing scheme would not be possible if the criterion applied is determined by local concepts of title. *Burnet* v. *Harmel*, *supra*. The only single standard capable of uniform application to transactions having common economic characteristics is one that classifies tax consequences by a taxpayer's rights in gross production of the oil or its proceeds. Whenever such a right exists, whether acquired or retained, there is an economic investment in the underlying oil which is subject to an allowance for depletion.

Helvering v. *Bankline Oil Co.*, 303 U. S. 362; *Helvering* v. *Twin Bell Syndicate, supra; Burnet* v. *Harmel, supra; Palmer* v. *Bender, supra; Thomas* v. *Perkins*, 301 U. S. 655. However, a depletable interest is not possessed by one who had such an investment but is no longer entitled to share in gross production, or by one who never acquired such a right, an interest in net profits not being considered as a share of production. *Helvering* v. *Elbe Oil Land Co., supra; Helvering* v. *O'Donnell, supra.*

If legal title to the oil in place is not of controlling significance, much less should other differences under local law with respect to the legal relationship existing between vendor-vendee, lessor-lessee, sublessor-sublessee, and assignor-assignee be made the standard, with the result that a taxpayer entitled to a particular kind of payment would be granted the allowance for depletion under one relationship but denied it under another. It has been suggested that the reversionary rights of a lessor distinguish a lease from a sale, so that a net profit payment is depletable when received by a lessor or a sublessor but is not when received by a vendor or assignor.[8] How-

[8] *Innis* v. *Commissioner*, decided June 29, 1945 (1945 P-H T. C. Memorandum Decisions Service, par. 45,246) (pending on the Government's appeal in the Circuit Court of Appeals for the Ninth Circuit); *Williams Bar Dredging Co.* v. *Commissioner*, decided June 30, 1945 (1945 P-H T. C. Memorandum Decisions Service, par. 45,244) (pending on the Government's appeal in the Circuit Court of Appeals for the

ever, in *Palmer* v. *Bender, supra,* the Court explicitly rejected the notion that the existence or absence of a reversionary interest has any material bearing on the problem. In addition, we wish to point out that the presence of a reversionary interest may be of little economic significance. The usual oil and gas lease extends for as long as oil and gas may be produced in paying quantities. See 2 Summers, *The Law of Oil and Gas,* Section 284, *et seq.* Thus, the lessee is entitled to extract all the underlying oil, or may continue to do so until production is no longer profitable. Since, upon expiration of the lessee's term, the lessor's reversionary interest may attach to oil reserves that have become exhausted or depleted beyond the point where production would be feasible, it can scarcely be considered that a lessor who does not retain an interest in gross production has any different economic interest in the oil deposits from that of a vendor or assignor.

Nor do we find anything else peculiar to the lessor-lessee relationship which would, without regard to the type of payment reserved, lead to the conclusion that a lessor always has an economic interest in the deposits. The fact that affirmative obligations, such as the duty to drill,

---

Ninth Circuit); *Gracey* v. *Commissioner*, 5 T. C. 296, 301–305 (pending on cross-appeals in the Circuit Court of Appeals for the Fifth Circuit); *Felix Oil Co.* v. *Commissioner*, decided December 18, 1942 (1942 P-H B. T. A. Memorandum Decisions, par. 42,662), affirmed, 144 F. 2d 276 (C. C. A. 9th).

may be imposed on the lessee, or that the lessor may reacquire the exploitation rights if there has been a forfeiture or abandonment, are not singular characteristics of leasing agreements. Similar provisions may appear in other kinds of transfers. Indeed, variations appearing from instrument to instrument make sport of any attempt to classify the legal relationship of the parties respecting the oil in place into closed compartments labelled "sales", "leases" and "assignments". For example, in the present case, Gulf executed (R. 35) an "assignment" which recited that it "has sold, conveyed and transferred * * * all oil and gas rights, titles, interests or privileges" with respect to the lease. In all material respects, the situation cannot be differentiated from the "sale" of the leases involved in the *Elbe* case,[7] in which the "purchaser" undertook to pay all oil royalties and to fulfill all drill-obligations imposed by the original leases, and the properties could be reacquired by the "vendor" if the purchaser elected not to continue operations.[8] The same obligations were assumed in the present case, in which the taxpayer undertook the payment of the overriding and

[7] The fact that Gulf retained the right to produce sulphur (R. 38) cannot have any bearing on whether it retained an economic interest in the oil deposits. Also, the provision (R. 38–39) that entitled Gulf to purchase the oil and gas produced by paying the average posted price, while giving Gulf an economic advantage, does not evidence a depletable interest. *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362.

[8] R. 45–47, 55–58, 60, No. 446, October Term, 1937.

underlying royalties, was obligated to continue the drilling requirements under the original lease, and agreed to reassign the properties to Gulf if the taxpayer desired to discontinue operations (R. 35–36). Again, it may be observed that even when a transaction is denominated a sale, the relationship of the parties may not be distinguishable in any respect from that involved in a typical leasing agreement. *West* v. *Commissioner*, 150 F. 2d 723 (C. C. A. 5th), certiorari denied, January 28, 1946, Nos. 667, 668, 669, and 670, this Term.

We submit that, as is true of title, other variations in the legal relationship of the parties cannot be resorted to as the standard for determining the decisive question. These variations, which also have their foundation in local rules of law, would not permit the uniform operation of the taxing statute intended by Congress. *Burnet* v. *Harmel, supra.* Moreover, it is apparent that grave administrative difficulties would be encountered in attempting to weigh nuances of meaning if classification by some such standard should be required. Unless the door is to be opened so that skillful draftsmen may determine tax consequences merely by selecting the requisite name for the instrument and inserting the proper phrases, and unless the economic consequences of a transaction are to be ignored, the key to the distinction between the *Kirby* and *Elbe* cases cannot be found in the kind of instrument involved or the fact that one was called a sale and the other

a lease. To the extent that the Tax Court has, in some cases, rested its decision on such a basis we believe that it has been in error. (See footnote 6, pp. 19–20, *supra.*)

We submit that only one consistent pattern is discernible from the decisions of this Court. The rule which, we believe, runs through all the decided cases may be stated thus: Regardless of the type of transfer involved and legal concepts respecting title to the oil in place, and regardless of any other rights and duties of the parties, a capital investment in the deposits which evidences a depletable interest only obtains where there is a continuing right to share in the gross production of the oil or the proceeds. Where this exists and the recipient has an additional right to share in net profits from operations, his basis for percentage depletion, i. e., the "gross income from the property", includes both payments, and an amount equal to both payments is to be excluded from the payor's gross income as "rents or royalties" paid. *Kirby Petroleum Co.* v. *Commissioner, supra.* Where there is no right to share in gross production, an interest in net profits is not depletable; since the recipient does not have any present and continuing rights to production, the payor may not exclude the payments as "rents or royalties".[9] *Hel-*

[9] The net profit payments are clearly not "royalties" (*Anderson* v. *Helvering*, 310 U. S. 404, 409) and, when paid to one who has given up his present rights to production, they can scarcely be considered as "rents". See footnote 3, p. 8, *supra.*

vering v. *O'Donnell, supra; Helvering* v. *Elbe Oil Land Co., supra.* The Tax Court, on occasion, has considered that the presence or absence of a royalty interest determines whether an interest in net profits is depletable. *Estate of Japhet* v. *Commissioner,* 3 T. C. 86, 93; *Crawford* v. *Commissioner,* decided March 24, 1944 (1944 P-H T. C. Memorandum Decisions, par. 44,098), affirmed, 148 F. 2d 776 (C. C. A. 9th), affirmed January 28, 1946, No. 197, this Term.

As a result of the *Kirby* decision, an interest in net profits resembles a cash payment which is depletable as a bonus [19] when the recipient has continuing rights to share in production by way of an oil royalty (*Burnet* v. *Harmel, supra; Bankers Coal Co.* v. *Burnet,* 287 U. S. 308), but is not depletable by the recipient or excludible by the payor when it is not associated with a royalty interest (*Helvering* v. *O'Donnell, supra; Helvering* v. *Elbe Oil Land Co., supra; Anderson* v. *Helvering, supra*).

Such a rule is not only in accord with the previous decisions of this Court but has the obvious advantage of avoiding undue administrative complexity in the administration of a statute which

[19] We do not suggest that a net profit payment is identical with a bonus, which is considered as "payment in advance for oil and gas to be extracted". *Herring* v. *Commissioner,* 293 U. S. 322, 324. It resembles a cash payment, however, in that its character as a depletable interest can only be determined from the economic investment of the recipient with which it is associated.

was intended to provide "a rule of thumb". *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, 321. Even if arguments of equal weight could be advanced in support of a rule based on distinctions between subleases and assignments, we submit that simplicity of administration is the "expediency" which should "tip the scales" in favor of the principle contended for by the Commissioner. Cf. *Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 330.

Under such a view, when Gulf transferred its interest without retaining any right to future gross production, it no longer had an economic interest in the oil deposits, its share of the net profits was not "gross income from the property" with respect to which it would be entitled to depletion, the taxpayer did not obtain any proceeds from the sale of oil belonging to Gulf, and there is no warrant for the taxpayer's exclusion of the payments from its gross taxable income as a "rent or royalty paid."

3. The taxpayer agrees with the Commissioner's contentions that the formalities of the instrument and the presence or absence of legal title to the oil in place are immaterial considerations (Br. 7–11). It also, apparently, admits that no distinctions are to be drawn between subleases and assignments, and concedes that the retention of a reversionary interest is not of controlling significance (Br. 23–24). With these irrelevant factors discarded, as they should be, the issue between the parties is focused on the taxpayer's

principal contention (Br. 12), that Gulf's "right to receive [net profit] payments which depend solely upon the production and sale of the oil in place to which Gulf must look for the return of its capital investment is of and in itself an economic interest * * *" and the corollary proposition that (Br. 20): "* * * there is no essential difference between a gross royalty and one payable out of net profits * * *."

The taxpayer's argument, however, is necessarily negated by the ruling of the *Kirby* decision that the right to receive net profits from operations is not a depletable interest unless it is associated with an economic interest in the oil in place. We have already demonstrated that the *Kirby, O'Donnell* and *Elbe* decisions refute the taxpayer's premise that such an interest in net profits is depletable by itself. The taxpayer has altogether failed to point to any economic interest of Gulf which is associated with its interest in net profits.

As a result, the taxpayer is forced to distinguish the *Elbe* case on grounds which are most infirm. It is first asserted that the *Elbe* case differs from the present one because the former involved a large cash payment and that a sale would have been involved there even if the transferor had retained a royalty interest payable after the transferee had been reimbursed for the costs of acquisition (Br. 20). We submit that this is a misconception of the decision. If such a royalty interest had been retained, the

Elbe case could have been quite similar to a typical bonus situation. See *Burnet* v. *Harmel*, *supra*. But it was because there were no royalties retained and because the right to receive net profits was not the retention of an "investment" in the oil, that a sale was considered as having taken place in the *Elbe* case.

If, in the present case, Gulf had also received a cash payment, this alleged difference between the cases would not exist. Yet, despite the taxpayer's reliance on the cash payment as a differentiating factor, it also (somewhat contradictorily) states (Br. 12) "* * * if Gulf had received a cash bonus for the execution of the instrument here involved, such a cash payment would have been ordinary income * * *."

Where developed properties are transferred, as in the *Elbe* case, the transferor may be able to obtain a cash payment since the transferee will not be required to pay development expenses. Where the properties, as here, are not developed and the transferee assumes a much greater risk of losing the money which must be invested before it can be determined whether oil will be found in paying quantities, the transferee may pay only a nominal cash consideration or none at

[11] *Bankers Mortgage Co.* v. *Commissioner*, 141 F. 2d 357, rehearing denied, 142 F. 2d 130 (C. C. A. 5th), certiorari denied, 323 U. S. 727, relied on by the taxpayer (Br. 20) is not contrary. The effect of that decision is to hold that a present sale can take place where the transferor does not retain a present interest in gross production but may reacquire one in the future, depending upon certain contingencies.

all. Yet, we submit, the transferor's relationship to the oil resulting from an interest in net profits is not essentially different in either situation. Unless the transferor retains an interest in gross production by way of oil royalties, the receipt of a portion of net operating profits is not its "gross income" from the sale of oil "even though continued production is essential to the realization of such profits." (*Anderson* v. *Helvering*, *supra*, page 409.)

The taxpayer also attempts to differentiate the *Elbe* case on the ground that the parties there intended a sale of the properties (Br. 17). We do not believe that such an intention is any more controlling than is the form of the instrument chosen. In addition, as we have already shown, the instrument here possesses as many indications that a sale was intended as was true in the *Elbe* case. See *supra*, pp. 13, 21–22.)

We fail to see what significance can be attached to the fact that the properties conveyed in the *Elbe* case were already producing oil in paying quantities while here development had not yet taken place (Pet. Br. 17). Nor do we believe that the character of the net profit payments in the *Elbe* case was any different from those involved here even though, in the former case, the cash payments were to be deducted before net profits could arise.[12] While no cash payments were made

[12] It may be noted that in *Commissioner* v. *Crawford*, *supra*, net profits were to be payable only after the lessees had been reimbursed for the cash payments made.

to Gulf, the net profits payments here, too, would be made only after development costs had been recouped by the taxpayer. Such expenses, which would normally exceed income during the period of development, might result in no net profits being payable to Gulf for some time after oil was discovered in paying quantities.[13]

Even if the *Elbe* case could be satisfactorily distinguished on any of these grounds, it is apparent that there can be no escape from the *O'Donnell* decision where no cash payment was involved. If Gulf's relationship to the property is to be determined only from its right to receive a portion of the operating profits, it is difficult to see how Gulf, by retaining an interest in net profits, reserved any more of a depletable interest than was obtained by the taxpayer in the *O'Donnell* case, who also acquired only the right to share in such profits. Indeed, the *O'Donnell* case refutes the taxpayer's basic assumption that the right to receive such payments is no different than the right to receive oil royalties, it being well settled that even a stranger to the property who acquires the right to share in gross production acquires a depletable interest in oil in place. *Fleming* v. *Commissioner*, 121 F. 2d 7 (C. C. A. 5th); *Lee* v. *Commissioner*, 126 F. 2d 825 (C. C. A. 5th);

[13] It may be noted that, although the taxpayer proceeded to develop the properties shortly after the acquisition of the working interest in 1933 (R. 39), only $17,406.19 of net profits was payable to Gulf in 1936, while $232,498.94 was payable in 1937.

Laster v. *Commissioner*, 128 F. 2d 4 (C. C. A. 5th).

4. Finally, we wish to point out that if the payments to Gulf are not to be excluded from the taxpayer's gross income, the taxpayer may not achieve the same tax result by deducting the payments as ordinary and necessary business expenses under Section 23 (a) of the Revenue Acts of 1934 and 1936 (Appendix, *infra*, p. 32). The payments made are clearly consideration for the taxpayer's acquisition of its economic interest in the minerals and, as such, are part of the "purchase price". *Helvering* v. *Elbe Oil Land Co.*, *supra*, page 375. Since the payments constitute the cost of the property, they enter into the basis under Section 113 (a) of the applicable Revenue Acts (Appendix, *infra*, p. 33) which, by Section 114 (b) (1), is specifically made the basis for depletion allowable under Section 23 (m).[14] The taxpayer's capital investment being returnable by the depletion allowance, it may not obtain a multiple return by deducting a capital item as an expense. *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459; *Schermerhorn Oil Corp.* v. *Commissioner*, 46 B. T. A. 151; *North American Oil Consolidated* v. *Commissioner*, 12 B. T. A. 68, reversed on other grounds,

[14] It is not material that the taxpayer may be entitled to percentage depletion in excess of cost depletion. The former is an arbitrary allowance replacing discovery depletion which may result in deductions greatly in excess of all depletable capital costs, but the depletion allowance may not be less than that based on cost. It will be noted that, in this case, cost depletion is allowable for 1938. (R. 52.)

50 F. 2d 752 (C. C. A. 9th), affirmed, 286 U. S. 417; *Quintana Petroleum Co.* v. *Commissioner, supra.* But see *Innis* v. *Commisioner, supra.*

In this connection, it may be observed that the taxpayer's hardship argument (Br. 25–26) is without foundation.[15] If the taxpayer had paid a stipulated cash consideration in installments for acquiring its working interest in the property, it would not have been entitled to a return of its capital except by the allowance for depletion. It is not to be placed in a preferred position because the consideration is measured by its operating profits.

CONCLUSION

The judgment of the Circuit Court of Appeals is correct and should be affirmed.

Respectfully submitted.

J. HOWARD MCGRATH,
Solicitor General.

SEWALL KEY,
Acting Assistant Attorney General.

HELEN R. CARLOSS,
HILBERT P. ZARKY,
Special Assistants to the Attorney General.

MARCH 1946.

---

[15] The depletion deductions allowable to the taxpayer (if the decision below is affirmed) may be compared with the net profit payments made to Gulf which, the Commissioner contends, constitute part of the taxpayer's capital cost of acquiring the property (R. 12, 15, 39, 41):

Year	Depletion Allowable	Payments to Gulf
1936	$150,533.20	$17,406.19
1937	249,599.64	232,498.94
1938	286,128.23	286,128.28

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the ap-

proval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).)

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*— The basis of property shall be the cost of such property; * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

(1) *General Rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than

it would be if computed without reference to this paragraph.

The corresponding provisions of the Revenue Act of 1934, c. 277, 48 Stat. 680, are substantially the same.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 22 (a)–1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. * * *
>
> * * * * * *
>
> ART. 23 (a)–1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 23 (b)–1 to 23 (q)–1. Double deductions are not permitted. Amounts deducted under one provision of the Act cannot again be deducted under any other provision of the Act. * * *
>
> ART. 23 (m)–1 [as amended by T. D. 5413, 1944 Cum. Bull. 124]. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*— * * *
>
> * * * * * *

(g) The term "gross income from the property," as used in sections 114 (b) (3) and 114 (b) (4) (A) and articles 23 (m)–1 to 23 (m)–28 of Regulation 94 * * * means the following:

In the case of oil and gas wells, "gross income from the property" as used in section 114 (b) (3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. If the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, or are transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation.

* * * * *

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in the form of bonus payments or advanced royalties (see article 23 (m)–10) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from "gross income from the property" for the taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the products sold during the taxable year.

* * * * * *

ART. 23 (m)–4. *Computation of depletion based on a percentage of income in the case of oil and gas wells.*—Under section 114

(b) (3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ percent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see article 23 (m)-1 (*g*) and (*h*).) In no case shall the deduction computed under this article be less than it would be if computed upon the cost or other basis of the property provided in section 113.

* * * * *

The corresponding provisions of Treasury Regulations 86, promulgated under the Revenue Act of 1934, are substantially the same.

U. S. GOVERNMENT PRINTING OFFICE: 1944

-Main Upstairs J p. 1

SUPREME COURT OF THE UNITED STATES.

No. 361. OCTOBER TERM, 1945.

Burton-Sutton Oil Company, Incorporated, Petitioner,
vs.
Commissioner of Internal Revenue.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[April 22, 1946.]

Mr. Justice REED delivered the opinion of the Court.

The taxpayer, the petitioner here, is the operating company for the production of oil from Louisiana lands. The taxpayer acquired a contract from J. G. Sutton, grantee in the contract, that imposed upon the grantee the obligation to develop the oil-land. For that purpose the contract transferred to the grantee all oil rights previously obtained by S. W. Sweeney by a lease from the owners of the land, the Cameron Parish School Board. Through another transaction the grantor in the Sutton contract, the Gulf Refining Company of Louisiana, acquired these rights from Sweeney. An underlying oil royalty was retained by the School Board and an overriding oil royalty by Sweeney. The contract between Gulf and Sutton required the grantee-operator, who is now this taxpayer, to pay to the grantor, Gulf, 50% of the proceeds of the oil produced and sold from the land, deducting from the proceeds certain itemized expenses of the producer. Those expenses are so general in character that it may be said fairly that Gulf was to receive 50% of the net from operations.

The issue here is the correctness of the taxpayer's manner of handling this 50% net from operations, paid to Gulf, in its return for federal income tax for its fiscal years ending during 1936, 1937 and 1938 under the Revenue Acts of 1934 and 1936. The taxpayer deducted these payments of 50% of net income from its income for each of the years from the oil sold from the property. It claimed that Gulf retained an economic interest in the oil in place to the extent of this 50% payment. The Tax Court upheld the Commissioner's inclusion of an amount equal to these 50% payments in the taxpayer's gross income. They were included by the Commissioner in the income on the theory that the 50% payments represented capital investment by the taxpayer. That is, they were a part of the cost of the lease. 3 T. C. 1187. If this theory is correct, it is proper to add an

equivalent sum, as the Commissioner did, to the taxpayer's gross income.[1] The Circuit Court of Appeals affirmed the Tax Court. *Burton-Sutton Oil Co.* v. *Commissioner*, 150 F. 2d 621.

A decision on the category of expenditures to which these [illegible] disbursements belong affects both the operators who make them and the owners, lessors, vendors, grantors, however they may be classed, who receive them. If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other.[2] The decision below conflicts in principle with *Commissioner* v. *Felix Oil Co.*, 144 F. 2d 276. *Kirby Petroleum Co.* v. *Commissioner*, No. 56 this Term, decided January 28, 1946, involved payments of a share of net income by a producer but differs from this case because the lessor there was a landowner who reserved a royalty as well as a share in the net profits. Consequently we granted certiorari. — U. S. —.

The applicable provisions in the Revenue Acts for 1937 and 1936 and the Regulations thereunder are substantially the same for the two Acts. We insert below those that seem pertinent.

[1] The Commissioner and the Tax Court allowed the taxpayer depletion upon its entire income, so adjusted, under Section 114(b).

[2] Kirby Petroleum Co. v. Commissioner, No. 56 this Term, decided January 28, 1946, slip opinion pages 4 and 5; Anderson v. Helvering, 310 U. S. 404, 407.

[3] Revenue Act of 1936, Ch. 690, 49 Stat. 1648, 1660, 1686:

"SEC. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

[illegible]

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, . . . a reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. . . .

"SEC. 114. Basis for Depreciation and Depletion.

(b) *Basis for Depletion.*—

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. . . .

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

"ART. 23 (m)-1 [as amended by T. D. 5413, 1944 Cum. Bull. 124]. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—

(g) The term 'gross income from the property,' as used in sections 114(b)(3) and 114(b)(4)(A) and Articles 23(m)-1 to 23(m)-28 of Regulation 94 . . . means the following:

The issue of the character of these 50% payments is not settled, however, by the statutes or regulations. These prescribe the federal income tax accounting procedure after a determination that an expenditure of an operator is or is not a rent, a royalty or an ordinary business expense, but throw little light on what is a rent or royalty.

In the *Kirby* case, we held that a payment of a share of the net profits from oil production by the operator to the owner of the land was a rent or royalty and taxable to the landowner as income from the oil property. Therefore the owner could take from the payment the 27½ per centum allowance for depletion provided by Section 114(b)(3)[1]. The reason given in the *Kirby* case for holding that the payment of a part of the net return from the property to the landowner was a royalty or rent[2] was that the owner had a capital investment—an economic interest—in the oil with a possibility of profit from that interest or investment solely from the extraction of the oil. As hereinbefore indicated, the landowner in the *Kirby* case had retained also a one-sixth oil royalty and had received a bonus. It was conceded that as both the bonus and the royalty represented a return for the sale in part of the lessor's investment in the oil in place, the lessor was entitled to depletion on both.[3]

The respondent urges that in the *Kirby* case it was the lessor's economic interest in some of the oil itself, or its proceeds, because of the bonus and royalty rights, which made the net profit payments subject to depletion in the lessor's hands; that net profits received are not depletable unless the recipient is entitled also to

---

[1] In the case of oil and gas wells 'gross income from the property' as used in section 114(b)(3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well.

"In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and which are not otherwise excluded from the 'gross income from the property.'"

[2] A reading of Section 114(b)(3) shows that the "gross income from the property" means income from the oil and gas wells on the property. Helvering v. Twin Roll Syndicate, 293 U. S. 312; Helvering v. Producers Corp., 303 U. S. 376, 382. Other income would not be depletable under that section. "Rents or royalties" in the section are those payable for the privilege of extraction.

[3] Kirby Petroleum Co. v. Commissioner *supra*, p. 2; Burnet v. Harmel, 287 U. S. 103, 111; Murphy Oil Co. v. Burnet, 287 U. S. 299, 302.

oil royalties.[6] Consequently, the Government contends that in this case where there is only a share in profits due to the assignor, Gulf, the *Kirby* case conclusion on the right to depletion should not be extended but that the judgment below should be affirmed on the ground that the profit payment was a part of the purchase price. In dealing with the operator's exclusion from gross income of agreed payments to lessors or assignors of leases out of net profits and with the lessor's or assignor's rights to depletion, the Tax Court has not followed consistently the principle that a reserved royalty is necessary to make a net profit payment depletable to the lessor and deductible from gross income from the property by the operator.[7] A number of the Tax Court cases

[6] The principle upon which the Tax Court and the Circuit Court of Appeals decided this case for respondent differs from respondent's present contention. This principle was that an obligation to pay a part of net proceeds is a personal covenant of the obligor and was the purchase price for the assignment. Burton-Sutton Oil Co. v. Commissioner, 150 F. 2d 621, 622; 3 Tax Court 1187, 1194, relying upon Quintana Petroleum Co. v. Commissioner, 143 F. 2d 588, 590-91; 44 B. T. A. 624, 627; Helvering v. Elbe Oil Land Co., 303 U. S. 372.

[7] In W. S. Green, 26 B. T. A. 1017, the lessor was allowed depletion on a net income payment in addition to his royalty on the ground that the net income payment was like a bonus.

In Marrs McLean, 41 B. T. A. 565, 573, which was decided after the Elbe case, the Tax Court said a transfer of leases for cash and a share of the profits was a sale. Where only a three-fourths interest in the lease was transferred and the transferor was to have one-fourth of the net profits, depletion was allowed the assignor.

In Felix Oil Co., docket No. 107148, decided December 18, 1942, a lessor corporation that had leased its oil lands for a cash payment plus 50% of the net profits as defined in the lease and no royalty, was held to have "retained an interest in the oil in place" through its ownership of the land. "Clearly, petitioner retained an interest in the oil produced because it could compel the lessee to sell 50 percent of the production to it where if it became dissatisfied with amounts realized by the lessee." Memorandum op., p. 7. See Commissioner v. Felix Oil Co., 144 F. 2d 277, affirming. Compare A. B. Innis, T. C. Docket Nos. 2735-2736, June 29, 1945.

In Kirby Petroleum Co., 2 T. C. 1258, 1261, the Tax Court relied on the latter ruling in Marrs McLean and held that the lessor could deplete its net profits payment, as well as its royalty. It later explained this ruling as based on the Kirby Company's retention of a "one-sixth oil royalty, thus reserving to itself an interest in the oil in place." Estate of Dan A. Japhet, 3 T. C. 86, 93.

In the Japhet case, depletion on net profits from an assignee's operation was denied an assignor of a lease who had received a cash payment but had not reserved a royalty. It was said no "economic interest" was reserved.

In A. B. Innis, T. C. Docket Nos. 2735-2736, June 29, 1945, a similar problem arose as to deductibility by gold lease operators from their gross income of a share in net profits paid to the sub-lessor of the lease. The Tax Court found no difference between such a payment to a sub-lessor and one to a lessor. Both were said to have economic interests and therefore depletable rights. Felix Oil Co., supra, was followed and Quintana, supra

on depletion and deduction cited in the preceding note did involve reserved royalties as well as payments of net profits. The *Felix Oil Company* and *A. B. Innis* did not. We do not agree with the Government that ownership of a royalty or other economic interest in addition to the right to net profits is essential to make the possesor of a right to a share of the net profit the owner of an economic interest in the oil in place. The decision in *Kirby* did not rest on that point.

To let the character of the net profit payments turn wholly on the ownership of a royalty of some sort by the one who received the net profit would make the right to depletion a form of words. No such mechanical application of a national tax act is desirable. Compare *Burnet* v. *Harmel*, 287 U. S. 103, 110-11. This taxpayer's acquisition of Sutton's contract with Gulf places the taxpayer in Sutton's situation as operator of the School Board lease. The School Board and Sweeney, the original parties to the lease, unquestionably have royalties which would compel a determination that net income payments would be subject to depletion if paid to them in addition to their royalties. It does not logically follow, it seems to us, that the mere receipt of the net income payments by different lessors or assignors can change the character of the taxpayer's arrangements from leases to purchases.

It seems generally accepted that it is the owner of a capital investment or economic interest in the oil in place who is entitled to the depletion. *Anderson* v. *Helvering*, 310 U. S. 404, 407; *Eulcon Jock Gracey*, 5 T. C. 296, 302; *Kirby Petroleum Co.* v. *Commissioner*, *supra*. Whether the instrument creating the rights is a lease, a sublease or an assignment has not been deemed significant from the federal tax viewpoint in determining whether or not the taxpayer had an economic interest in the oil in place. *Palmer* v. *Bender*, 287 U. S. 551, 557, 558. Nor has the title to

---

distinguished as a sale by assignment, rather than sublease. Williams Bar Dredging Co. is in accord. T. C. Docket Nos. 3284, 4074, June 30, 1945.

In Quintana Petroleum Co., 44 B. T. A. 624, an operator-assignee acquired an oil lease by an agreement that called for payment by the assignee to the assignor of one-fourth of the net proceeds from the leased property with no reservation of royalty. The Board concluded that the assignment was a purchase and no deduction of the amount of net profits paid was allowable. See also Quintana Petroleum Co. v. Commissioner, 143 F. 2d 588.

In Eulcon Jock Gracey, 5 T. C. 296, 302, decided June 21, 1945, the Tax Court under similar circumstances followed Quintana and held an operator assignee was entitled to depletion on gross production but could not exclude the net profit payment to his assignee from his gross, as the transfer of the lease, in consideration of a net profit payment only, was a sale.

the oil in place been considered by this Court as decisive of the capital investment of the taxpayer in the oil.[8] Technical title to the property depleted would ordinarily be required for the application of depletion or depreciation. It is not material whether the payment to the assignor is in oil or in cash which is the proceeds of the oil, *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, 321, nor that some of the payments were in the form of a bonus for the contract. *Burnet* v. *Harmel*, 287 U. S. 103, 111; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, 302. Congress, however, has recognized the peculiar character of the business of extracting natural resources.[9] Leases are a method of exploitation of the land for oil and payments under leases are "income to the lessor, like payments of rent."[10] Receipts from oil sales are gross income to the operator and subject to statutory deductions. Since lessors as well as lessees and other transferees of the right to exploit the land for oil may retain for themselves through their control of the exploitation of the land valuable benefits arising from assets dependent upon the extraction of the oil,[11] Congress provided as early as the Revenue Act of 1918[12] for equitable apportionment of the depletion allowance between them to correct what was said to be an existing inequality in the law or its administration.

[8] 287 U. S. at 557: "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital."

287 U. S. at 558: "Even though legal ownership of it, in a technical sense, remained in their lessor, they, as lessees, nevertheless acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute." Lynch v. Alworth-Stephens Co., 267 U. S. 364; Burnet v. Harmel, 287 U. S. 103, 109-10; Bankers Coal Co. v. Burnet, 287 U. S. 308; Kirby Petroleum Co. v. Commissioner, *supra*, p. [illegible].

[9] Stratton's Independence v. Howbert, 231 U. S. 399, 413-14.

[10] Burnet v. Harmel, 287 U. S. 103, 107 s.

[11] See Lynch v. Alworth-Stephens Co., 267 U. S. 364, 370; Palmer v. Bender, 287 U. S. 551, 556.

[12] 40 Stat. 1057, 1067, 1078, §§ 214(a)(10), 234(a)(9).

[13] H. Rep. No. 767, 65th Cong., 2d Sess., September 3, 1918, Deductions (5) and for corporations, Deductions (4).

The inequality referred to under the Revenue Act of 1916, 39 Stat. [illegible] Sec. 5, Eighth (a), arose from the preferred treatment given the lessee over the lessee. See Hearings, House Committee on Ways and Means, 65th Cong., 2d Sess., pp. 455, 516-17, 523-28, 530-31. Regulations 33, Income Tax promulgated January 2, 1918, Art. 170; Regulations 45, 1920 ed., Income Tax promulgated January 28, 1921, Art. 201.

The applicable law for allowance of depletion in oil and gas wells appears in Sec. 114(b)(3). It is identical with I. R. C. Sec. 114(b)(3). This sec-

In the present case, the assignor of the petitioner before assignment had an economic interest in the oil in place, through its control over extraction. Under the contract with petitioner, its assignor retained a part of this interest—fifty per cent of net. Like the other holders of such economic interest through royalties, the petitioner looked to the special depletion allowances of Section 114 b (3) to return whatever capital investment it had. The cost of that investment to the beneficiary of the depletion under Section 114 b (3) is unimportant. Depletion depends only upon production. It is the lessor's, lessee's or transferee's "possibility of profit" from the use of his rights over production, "dependent solely upon the extraction and sale of the oil," which marks an economic interest in the oil. *See Kirby Petroleum Co. v. Commissioner, supra*, page 4. Through retention of certain rights to payments from oil or its proceeds in himself, each of these assignors of partial exploitation rights in oil lands has maintained a capital investment or economic interest in the oil or its proceeds.[14] As the oil is extracted and sold, that economic interest in the oil in place is reduced and the holder or owner of the interest is entitled to his equitable proportion of the depletion as rent or royalty. The operator, of course, may deduct such payments from the gross receipts.

Of course, such a transferor, whether the landowner or any intermediate assignor, may completely divest himself of any interest, economic or otherwise, in the extraction of the oil. As the record shows no reservation of an economic interest by Sutton, the assignee of Gulf and the assignor of petitioner, he appears to have done so in this case. *See Helvering v. Elbe Oil Land Co.*, 303 U. S. 372. While, as pointed out above, the payment of proceeds in cash, the form of the instrument of transfer and its effect on the title to the oil under local law are not decisive of the right

---

tion is the result of administrative experience with oil and gas depletion. Hearings, Sen. Com. on Finance, 69th Cong., 1st Sess., p. 177-78; Hearings, House Com. on Ways and Means, 69th Cong., p. 1006. See H. Rep. No. 1, 69th Cong., 1st Sess., December 7, 1925, Discovery Value; § 204 (c) (2), 44 Stat. 16. For discussion see Helvering v. Twin Bell Syndicate, 293 U. S. 312, and Kirby Petroleum Co. v. Commissioner, *supra*, p. 3. Depletion is now an arbitrary percentage allowance based on production from the wells without regard to cost or value of the property.

[14] A participation in net profits disassociated from an economic interest does not enable a recipient of such profits to benefit from depletion. Helvering v. O'Donnell, 303 U. S. 370.

to participation in depletion under Sections 23(m) and 114(b)(3), there must be a determination under federal tax law as to "whether the transferor has made an absolute sale or has retained" such economic interest as we have just described in the preceding paragraph. *Kirby Petroleum Co.* v. *Commissioner*, *supra*, page [illegible]. We have said that the instrument should be construed as a sale when a large cash payment was made with a reserved payment that could be satisfied by future sales of the transferred property without extraction of the oil. Obviously there could be no depletion without extraction. *Anderson* v. *Helvering*, 310 U. S. 404, 412. On the other hand, we have construed an assignment of oil leases for cash and a deferred payment, "payable out of oil only if, as and when produced," as the reservation of an economic interest in the oil—not a sale. *Thomas* v. *Perkins*, 301 U. S. [illegible].

The Government contends that *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372, controls this case. The transfer of the leases in *Elbe* was held an absolute sale. There the transfer was for cash, deferred payments in cash, if the assignee did not take advantage of a stipulation for abandonment, and a one-third interest in the net profits of the assignee. It was further provided that Elbe, the assignor, after the transfer, should have "no interest in or to said properties," except in the case of an abandonment of the property by the assignee. This provision for the transfer of all interest of the assignor was emphasized as a significant part of the agreement for transfer. The issue upon which this Court passed was the classification of the deferred payments. Were they gross income from the property or receipts from a sale of the leases? These deferred payments were not payable out of oil sales but were payable absolutely, unless there was an abandonment. This Court concluded that the addition of a provision for the payment of a share of net profits did not qualify "in any way the effect of the transactions as an absolute sale." Page 377. In view of what we have said in this and in the *Kirby Petroleum* case as to the economic interest in the oil of a recipient of a share of net profits, the holding of *Elbe* should not be extended to the facts of this agreement.

The assignor, Gulf, in the assignment here involved, required the grantee to drill promptly, to account for production, to pay over fifty per cent of receipts, less agreed costs and expenses, and to sell the production on defined terms to grantor, if grantee [illegible]

sised to purchase." This last clause did not appear in the Elbe contract. Such a transfer of rights to exploit could not, we think, properly be construed as a sale. It is rather an assignment to the operator, petitioner here, of the right to exploit the property with a reservation in the assignor of an economic interest in the oil.

Reversed.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

Mr. Justice BLACK and Mr. Justice DOUGLAS dissent.

---

15 See the discussion of Felix Oil Co. in note 7, *supra*.

SUPREME COURT OF THE UNITED STATES.

No. 331.—October Term, 1945.

Burton-Sutton Oil Company, Incorporated, Petitioner, vs. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[April 22, 1946.]

Mr. Justice Frankfurter, [redacted].

The tortuous process by which the result in this case has evidently to be reached by the Court justifies calling attention again to the present unsatisfactory state of tax litigation. It is of course idle to expect that the complexities of our economic life permit revenue measures to be drawn with such simplicity and particularity as to avoid much litigation. But it is not a counsel of perfection to assume that a system of judicial oversight of fiscal administration can be devised sufficiently rational to avoid the mollifying series of cases relating to income from oil operations culminating in the present (at least in this case). The Court made a brave effort in *Dobson v. Commissioner*, 320 U. S. 489, to meet some of the difficulties of the present distribution of judicial authority in tax cases by lodging practical finality in a Tax Court decision unless it invokes a "clear-cut mistake of law." *Id.* at 502. An attempt to give adequate scope to such a doctrine of judicial abstention by dealing with the practicalities of tax matters instead of relying on the grab-bag concepts of "law" and "fact" as a basis of review has not, however, commended itself to the Court. See *Trust of Bingham v. Commissioner*, 325 U. S. 365.

To be sure even the adoption of this view would not make the Tax Court the Exchequer Court of the country inasmuch as tax litigation can go through the district courts as well as through the Tax Court. It would, however, largely centralize review in the Tax Court of Treasury determinations, assuming that the bulk of tax litigation will continue to find its way to the Tax Court.

It is suggested that the Tax Court makes differentiations from

case to case which to the uninitiated look suspiciously like conflicting opinions. But it is impossible to escape nice distinctions in the application of complicated tax legislation. And so far as over-nice distinctions are to be made, I do not see that it helps the administration of law for this Court rather than the Tax Courts to make them.

Nothing better illustrates the gossamer lines that have been drawn by this Court in tax cases than the distinction made in the Court's opinion between *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372, and this case. To draw such distinctions, which hardly can be held in the mind longer than it takes to state them, does not achieve the attainable certainty that is such a desideratum in tax matters, nor does it make generally for respect for law. Perhaps it is inherent in the scheme which Congress has provided for review of tax litigation that we have such an unsatisfactory series of decisions as those which are sought to be reconciled by the present opinion. If so, then the call for legislation voiced in responsible quarters to reform the situation may well be heeded. See *e. g.*, Griswold, *The Need for a Court of Tax Appeals*, 1944 57 Harv. L. Rev. 1153.